Australian Capital Territory

Building (Prudential Standards) Determination 2005

Disallowable Instrument DI2005-250

made under the

***Building Act 2004,* Section 103 – Prudential Standards**

EXPLANATORY STATEMENT

Background

Divisions 6.4 and 6.5 of the *Building Act 2004* (the Act) contain provisions for a fidelity fund scheme that provides consumer protection under the Act. Section 103 of the Act allows the Minister administering the Act to determine prudential standards for a scheme and sets out topics that may be provided for. This is the second instrument created under this section and contains some minor updates to the original instrument created on 23 May 2002.

The prudential standards are concerned with the sound financial management of a fidelity fund scheme. They set out the eligibility of the trustees for a scheme, and of the auditor and actuaries, the duties of the auditor and actuary, and risk management requirements. These include the regular calculation of liabilities, requirements for capital adequacy, the preparation of compliance and contingency plans, the acceptable investment of the funds held by the scheme and reporting to the trustees and the government.

For some of their requirements the prudential standards refer to other documents. The continuing eligibility criteria for trustees are the same as those that trustees must meet under approval criteria if a fidelity fund is to be initially approved. The approval criteria are a disallowable instrument made under section 99 of the Act. The valuation of a fidelity fund scheme's liabilities must follow prudential standard GPS 210 (Liability valuation for general insurers) July 2002 issued by the Australian Prudential Regulation Authority and a copy of that document is appended. Clause 35 provides that money in an approved scheme that is not immediately required for the purposes of the approved scheme may be invested in any manner authorised by the *Financial Management Guidelines.* These are guidelines created under the *Financial Management Act 1996.*

A modification to the *Building Act 2004* creating section 164C provides that the Prudential Standards under the *Building Act 1972* are the Prudential Standards under the *Building Act 2004*. As a modification made under section 152, Section 164C expires one year after the commencement of the Act. Prudential Standards created

under *Building Act 1972* will therefore lapse and new Prudential Standards must be created.

This determination differs from the original Prudential Standards Determination created in 2002 in the following ways:

- references to certain sections of the Act have been renumbered in subsequent versions of the Act. Amendments have been made to reflect a change in numbering used between the repealed *Building Act 1972* and the current Act.
- provisions requiring the trustees of fidelity funds to provide reports to the Minister within 60 days have been amended to require reporting within 90 days. This is due to difficulties experienced by fidelity fund trustees in meeting the current requirements on time.
- a reference in paragraph 35 relating to the investment of monies not immediately required by the scheme has been changed from the *Trustees Act 1925* to the *Financial Management Guidelines* under the *Financial Management Act 1996*.

Certain clauses in this determination (listed below) make provision for the Minister to make certain determinations. These determinations are disallowable instruments.
Clause 10 – matters to include in audit of approved scheme;
Clause 18 – method of calculating net tangible assets;
Clause 19 – types of investments scheme may invest in;
Clause 20 – trustees to provide Minister certificate from auditor certifying value of net tangible assets;
Clause 22 – Minister may request solvency report at any time;
Clause 24 – methodology for the valuation of an approved scheme's liabilities;
Clause 28 – matters for valuing an approved scheme's outstanding requests liabilities and fidelity certificate liabilities;
Clause 30 – matters for consideration when calculating the appropriate amount of contributions;
Clause 32 – purpose for which a scheme is maintained; Clause 34 – purposes for which assets may be applied;
Clause 35 – allowable investments;
Clause 39 – approval of short term loans (up to 90 days) for certain purposes;
Clause 40 – permit money to be borrowed if other than provided for in clause 39;
Clause 42 – requirements for annual accounts;
Clause 44 – documents which are to be retained for 10 years;
Clause 51 – matters to be included in a contingency plan;
Clause 57 – require trustees to report to Commissioner for Fair Trading regarding certain matters.

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Notes on clauses to Schedule 1
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1 This clause gives the meaning of terms used in the prudential standards.

Ongoing standards for trustees

2-4 A trustee is required, for the duration of their appointment, to meet the criteria in clause 11 of the approval criteria. The criteria include such things as citizenship, competence, requirements for professional indemnity insurance, and conflict of interest. To be appointed as a trustee, a person must satisfy the Minister that they meet the criteria set out in clause 9 (a trustee must be a natural person) and 11 of the approval criteria within 30 days of their appointment.

Once the trustee believes they may no longer satisfy the approval criteria in clause 11 or any requirements within the Determination, they must immediately advise the other trustees and the Minister in writing.

Auditor and actuary of an approved scheme

5-9 Sub-section 112(2) of the Act requires criteria to be set for the appointment of an auditor and actuary. A trustee cannot act as the actuary or auditor, and the auditor and actuary must not be the same person.

Both the auditor and actuary must possess the appropriate qualifications and be a member of their professional body, with at least 5 years experience in the general insurance industry or in acting for an approved scheme. They must not have any conviction for an offence that relates to the conduct of their professional responsibilities, or have been declared insolvent (as defined in *the Corporations Act 2001 (Cth)*).

The auditor and actuary must both be able to demonstrate that they have no actual or potential conflict of interest. In addition, the Australian Prudential Regulation Authority, under section 46 of the *Insurance Act 1973 (Cth),* must approve the auditor.

Auditor

10-12 The trustees must provide the auditor with a copy of the prudential standards. The auditor is required to audit the accounts of the approved scheme annually, and provide a certificate to the trustees certifying the financial position and capital adequacy of the scheme. The Minister may, in writing,

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require the auditor to include other matters in their certificate. The Minister's written direction is a disallowable instrument that must be notified and presented to the Assembly.

For the first 12 months of the approved scheme's operation, the auditor must provide an audit certificate every three months.

Actuary

13-15 The trustees must provide the actuary with a copy of the prudential standards. The actuary must provide a report to the trustees after the end of each financial year regarding the approved scheme's solvency, valuation of liabilities and required contribution rates for the issue of a fidelity certificate. The information must be in accordance with the requirements of clauses 22, 23 and 31 of these prudential standards.

The Minister has the power under the Act to require the trustees to appoint a special actuary to investigate a fidelity fund scheme. The Minister may, in writing, direct a special actuary to report on anything nominated by the Minister.

Actuarial matters

Capital adequacy

16-20 The trustees are required to maintain sufficient capital in the approved scheme, which is determined by the minimum value of the net tangible assets as set out in the table at clause 17. The Minister may in writing, determine a different method for calculating net tangible assets. The written direction of the Minister is a disallowable instrument.

The trustees are required to provide a certificate to the Minister that confirms the capital adequacy of the scheme. A certificate must be provided with any application for approval of a scheme, during the first 12 months of the approved scheme's operation, and within 90 days of the end of the financial year. The Minister may in writing request a certificate of capital adequacy at any other time. The written direction of the Minister is a disallowable instrument.

The assets of the approved scheme must be held within Australia, and may only be invested in real property, cash, secured loans, fully paid securities, or other assets determined in writing by the Minister. The written direction of the Minister is a disallowable instrument.

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Solvency

21-22 The trustees are required to ensure that the assets of the approved scheme can cover the potential financial obligations of the scheme, as determined by the actuary.

The actuary must provide a certificate to the trustees that he/she is satisfied with the solvency of the approved scheme. The trustees must provide the certificate to the Minister within three months (or longer if approved by the Minister) of the application for the approval of the scheme, and within 90 days after the end of each financial year. The Minister may in writing request the certificate of solvency at any other. The written direction of the Minister is a disallowable instrument. The Minister's agreement to the provision of the certificate later than three months after the application for approval is also a disallowable instrument.

Valuation of liabilities

23-28 The actuary is required to value the liabilities of the approved scheme. The valuation must include the value of the potential liabilities of the approved scheme prior to the calculation date, and any fidelity certificates relating to potential future requests for payment. The valuations must be calculated in accordance with prudential standard GPS 210 (Liability valuation for general insurers) issued by the Australian Prudential Regulation Authority, and any other matters determined in writing by the Minister. A written direction of the Minister is a disallowable instrument.

The trustees must provide the actuary's valuation to the Minister within 90 days of the end of the financial year, or at any other time if directed by the Minister in writing.

29-31 Prior to the commencement of the approved scheme, the actuary is required to calculate the amount of the initial contribution to be paid to an approved scheme to allow the issue of a fidelity certificate to an owner. The amount of the contribution must be recalculated at least once every six months. The actuary must advise the trustees of the calculated contributions.

In calculating the contribution amounts, the actuary must take into consideration the valuation of liabilities, the number of fidelity certificates already issued, and the potential liabilities arising from issued fidelity certificates. The Minister may also, in writing, determine other matters that the actuary must take into account. A written determination of the Minister is a disallowable instrument.

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The actuary must provide the trustees with a certificate of adequacy in relation to required contributions to the approved scheme. The trustees must provide the certificate to the Minister as part of an application to the Minister for approval of a scheme, within 90 days of the end of each financial year, and at any other time if requested in writing by the Minister.

Financial management of an approved scheme

32 The trustees are responsible for ensuring the approved scheme is maintained for the purposes of providing fidelity certificates in accordance with the Act and trust deed, and the payment of monies in accordance with any issued fidelity certificate. The Minister may also determine, in writing, other purposes of the approved scheme. A written direction of the Minister is a disallowable instrument.

Assets of an approved scheme

33-40 The trustees can only deal with the assets of an approved scheme in accordance with the prudential standards. The assets can only be used to meet liabilities or expenses incurred to maintain the operation of the approved scheme, to pay any claim made under a fidelity certificate, or to satisfy any other purpose determined in writing by the Minister. A written determination of the Minister is a disallowable instrument.

Investments can be made in accordance with clause 19 and 35 of the prudential standards. Where money in an approved scheme is not immediately required, it can be invested in any manner authorised by the *Financial Management Guidelines* under the *Financial Management Act 1996*, and in any other investment determined in writing by the Minister. A written direction of the Minister is a disallowable instrument.

The trustees must prepare and implement an investment strategy that takes account of the risks, assets, liquidity and prospective liabilities of the approved scheme. The trustees cannot mortgage or otherwise encumber any asset of the approved scheme.

The trustees can only borrow money in relation to the approved scheme to enable them to make a payment required by a fidelity certificate. This is only allowed if they are unable to make the payment through other means and the borrowing must be approved by the Minister. The Minister's approval is a disallowable instrument. The period of borrowing cannot exceed 90 days and must not exceed 10% of the value of the approved schemes assets. The Minister must be notified in writing of the

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borrowing.

The trustees may borrow money under other conditions that are approved in writing by the Minister. The Minister's approval is a disallowable instrument.

41-43 The trustees are required to keep accounting records for each financial year that include the transactions and financial position of the approved scheme. The records must be sufficient to enable the preparation of annual accounts that can be audited in accordance with clause 10 and must be kept for at least 7 years after the financial year to which the records relate. The preparation of annual accounts by the trustees must be in accordance with accounting standards and any other requirements specified in writing by the Minister. The Minister's written requirement is a disallowable instrument.

Management of an approved scheme

44 The trustees of an approved scheme are required to keep administrative records for at least 10 years. The documents include but are not limited to: minutes of meetings, records of decisions made by the trustees, compliance plans and contingency plans. The Minister may specify in writing any other document not listed in clause 44 that must also be kept for 10 years. The Minister's determination is a disallowable instrument.

Compliance plan

45-49 A compliance plan must be prepared, that specifies how the approved scheme is to operate. The plan must show how the trustees will ensure compliance with the Act and any conditions of approval specified under section 100 of the Act. A risk management strategy and reporting strategy must be included, which also specifies who is responsible for monitoring each identified risk. Any amendment to the plan must be provided to the Minister within 14 days of the trustees approving the amendment.

Compliance of the approved scheme with the plan must be monitored at least every three months. Any breach of the plan which is considered by the trustees to have a material adverse effect must be notified immediately to the Minister in writing. The assessment of the adequacy of the plan, and any breaches of the plan, must be included in the annual report to the Minister.

Contingency plan

50-54 A contingency plan must be prepared that specifies how any

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unforseen administrative difficulty caused by any event beyond the trustees' control would be managed. This could include a disaster, crime or systems failure. The plan must include arrangements to keep duplicate records on and off-site, availability of administrative and human resources, the role of service providers and the availability of financial resources to fund rectification work. The Minister may also determine in writing, other matters that must be included in the contingency plan. The Minister's determination is a disallowable instrument.

It is the responsibility of the trustees to ensure the necessary structures are in place to give effect to the contingency plan. If the contingency plan is activated, the trustees must advise the Minister in writing. Any changes to the contingency plan must be provided to the Minister within 14 days of the approval of the change.

Reporting Obligations

55 The trustees must provide an annual report to the Minister within 90 days of the end of the financial year. The report must include the annual accounts, the reports and certificates of the actuary and auditor as required by the Act, and a list signed and dated by two trustees that sets out any breach of the compliance plan. The trustees must also include declarations that they are satisfied that the compliance and contingency plans are adequate, and that the approved scheme is able to meet its liabilities when they become due and payable.

56 When the auditor has prepared a quarterly report and certificate under clause 11, the trustees must provide a copy of that certificate to the Minister as soon as practicable. The copy must be signed and dated by a trustee to certify it is a true copy.

57-58 Every decision of the trustees to pay or refuse a request under a fidelity certificate must be reported to the Commissioner for Fair Trading. The report must include the number of requests made for payment, the amount sought, the number of payment made and the amount for each payment, and the reasons for the rejection of any claim. The report must be made every three months, or within another time period specified by the Minister in writing. A written direction by the Minister is a disallowable instrument.

Matters specified under sections 101 and 102

59-60 The trustees are not required to gain the approval of the Minister to change the bank account of an approved scheme. Any change to a trust deed requires the approval of the Minister.

Prudential Standard GPS 210

Liability Valuation for General Insurers

Objective and Key Requirements of this Standard

This Prudential Standard establishes a set of principles for the consistent measurement and reporting of the insurance liabilities of all general insurers.

The appropriate valuation of insurance liabilities is one of the most important issues facing an insurer and its Board. It is important for the financial soundness of the insurer, and ultimately for the protection of policyholders, that insurance liabilities are valued in a realistic and consistent manner. It is ultimately the responsibility of the insurer's Board and senior management to place an appropriate valuation on the insurer's liabilities, after considering actuarial and other advice.

In developing this Standard, regard has been had to the requirements of AASB 1023 and to the merits, to both the preparer and user of the accounts, of establishing an integrated financial reporting framework for the insurance industry, ie a reporting framework that responds to the objectives of the statutory and general purpose reporting regimes and avoids, to the extent possible, dual reporting by the industry. At this stage, it is possible that for some insurers, there will be some inconsistency between this Prudential Standard and AASB 1023. From APRA's perspective, we believe this to be unavoidable if our prudential objectives are to be met.

The key requirements of this Prudential Standard are:

- The Board of an insurer that is required to have an Approved Actuary must obtain **written advice from the Approved Actuary** on the valuation of its insurance liabilities. This requirement is designed to aid Boards to perform their duties by ensuring they are adequately informed. It does not preclude a Board from obtaining advice from other sources (eg senior management, auditors and consultants).

- Insurance liabilities include both the insurer's Outstanding Claims Liabilities, and its Premiums Liabilities. **Outstanding Claims Liabilities** relate to all claims incurred prior to the calculation date, whether or not they have been reported to the insurer. **Premiums Liabilities** are future claim payments arising from future events insured under existing policies, assessed on a prospective basis.

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- The Approved Actuary must provide advice on the valuation of insurance liabilities at a given level of sufficiency - **that level is 75%** (or, in some circumstances, the central estimate plus one half of the coefficient of variation). In other words, the valuation of insurance liabilities provided by the Approved Actuary must include a risk margin over and above the central estimate.

- Insurance liabilities are to be valued on a **discounted basis.** The rate to be used in discounting is the risk-free rate; ie the gross redemption yield of a portfolio of sovereign risk securities with a similar expected payment profile to the insurance liabilities for a given class (eg the yield on Commonwealth Government securities should be used for Australian dollar liabilities).

- It is ultimately for the **Board of the insurer** to determine the appropriate valuation of insurance liabilities. However, in circumstances where the Board decides not to accept the Approved Actuary's advice, or to otherwise adopt a valuation of insurance liabilities (higher or lower) that is not in accordance with the principles of this Standard, this must be **disclosed** to APRA. Details should also be included in the insurer's published annual financial accounts.

Details on these requirements are contained below. Additional requirements relating to Approved Actuaries and Approved Auditors, including eligibility criteria and reporting requirements, are set out in *GPS 220 Risk Management.*

Prudential Standard

1. This Prudential Standard, made under section 32 of the *Insurance Act 1973* (the Act), applies to all general insurers authorised under the Act.

2. In determining the value of insurance liabilities, not all insurers will be required to have an Approved Actuary[1]. However, irrespective of whether actuarial advice is sought or required, an insurer's liabilities must be valued in accordance with the principles of this Standard.

The Role of the Approved Actuary in Valuing Insurance Liabilities

3. Subject to certain exceptions set out in Guidance Note GGN 220.1 Governance, an insurer must appoint an actuary (Approved Actuary) in accordance with the Act, and have this appointment approved by APRA. As well as any other responsibilities that may be assigned by APRA, the Approved Actuary must provide written advice to the Board of the insurer on the value of insurance liabilities in accordance with this Standard. Unless APRA provides written approval for less frequent advice, this must at a minimum occur on an annual basis to coincide with the preparation of the insurer's yearly statutory accounts. The Board of an insurer is free to seek more frequent advice if it believes this is to be appropriate.

Valuation of Insurance Liabilities

4. Where an insurer includes in its accounts a value for insurance liabilities which is inconsistent with the advice received from the Approved Actuary, or is not determined in a manner consistent with the principles of this Standard, the insurer must notify APRA in writing, and should include within its published annual financial accounts:

   (a) the reasons for not accepting the Approved Actuary's advice, or for not determining the insurance liabilities in a manner consistent with this Standard; and

   (b) details of the alternative assumptions and methodologies used for determining the value of the insurance liabilities.

5. In determining the value of its insurance liabilities, an insurer (after taking advice from its Approved Actuary, where necessary) must determine a value for both its Outstanding Claims Liabilities and its Premiums Liabilities for each class of business[2].

6. The Outstanding Claims Liabilities relate to all claims incurred prior to the calculation date, whether or not they have been reported to the insurer. The most significant component of the insurance liabilities for long tail business is the Outstanding Claims Liabilities. The value of the Outstanding Claims Liabilities must include an amount in respect of the internal expenses that the insurer expects to incur in settling these claims. The Outstanding Claims Liabilities are to be determined both net and gross of expected reinsurance recoveries.

7. The Premiums Liabilities relate to future claim payments arising from future events insured under existing policies. For short tail business, the Premiums Liabilities are of greater relative significance. The value of the Premiums Liabilities must include an amount in respect of the internal expenses that the insurer expects to incur in administering the policies and settling the relevant claims. The Premiums Liabilities are to be determined on a fully prospective basis; both net and gross of expected reinsurance recoveries (as a result, there is no need to separately report a deferred acquisition cost asset).

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[1] An Approved Actuary is an actuary appointed by the insurer under section 39 of the Act and approved by APRA under section 40.. For further details on the appointment and approval of actuaries, see GPS 220 and GGN 220.1. Requirements regarding an exemption form the requirement to appoint an Approved Actuary are contained in section 47 of the Act and GGN 220.1

[2] An insurer's insurance liabilities may also include its exposure from surety bond business, depending on the treatment adopted under paragraph 22 of GGN 110.4.

8. Subject to the requirements of this Standard, the valuations of an insurer's Outstanding Claims Liabilities and its Premiums Liabilities must be realistic estimates, determined having regard to considerations of consistency with the basis for valuing assets, and the requirements of relevant Australian Accounting Standards.

9. The valuation of insurance liabilities for each class of business must comprise:

   (a) a central estimate value of the Outstanding Claims Liabilities;

   (b) a central estimate value of the Premiums Liabilities; and

   (c) risk margins that relate to the inherent uncertainty in each of these central estimate values.

   The value of the insurance liabilities (for both Outstanding Claims Liabilities and Premiums Liabilities) is the sum of the central estimate and the risk margin.

10. The valuation of insurance liabilities should reflect the individual circumstances of each insurer. Notwithstanding this, to ensure that valuation processes are consistent and sufficiently rigorous across the industry, the risk margin should be established on a basis that is intended to secure the insurance liabilities of the insurer at a given level of sufficiency -- that level is **75 per cent**.

11. Due to the highly skewed nature of some insurance distributions, the level of sufficiency established in paragraph 10 may result in a value regarded as insufficient for prudent purposes. Therefore, the risk margin should not be less than one half of the coefficient of variation for the insurance liabilities of the insurer.

Determination by Class of Business

12. The principles for determining the central estimate values of the Outstanding Claims Liabilities and the Premiums Liabilities are, subject to considerations of materiality and the professional judgement of the Approved Actuary, to be applied to each class of business of the insurer.

13. For the purpose of disclosing the values of the insurance liabilities in the accounts, risk margins should be shown separately in relation to the Outstanding Claims Liabilities and the Premiums Liabilities. Risk margins should also be shown separately for each class of business.

14. Where the Approved Actuary thinks it appropriate, allowance for diversification and/or reinsurance should be made in determining the risk margin. The justification for and method of determining such diversification allowance and reinsurance recoveries should be clearly documented and reported by the Approved Actuary.

15. The value of the insurance liabilities (both for Outstanding Claims Liabilities and Premiums Liabilities) reported by the insurer will be the aggregate of the liabilities determined for each class of business.

16. In practice, the process of determining the central estimate values of the Insurance liabilities should be undertaken on the basis of a class of business. However, this should not prevent the Approved Actuary from undertaking the necessary analysis on a basis which is more suitable, taking into account the nature of the data and the particular circumstances of the insurer.

The Central Estimate

17. For the purposes of paragraph 9, the central estimate is intended to reflect the mean value in the range of possible values for the outcome (that is, the mean of the distribution of probabilistic outcomes). The determination of the central estimate should be based on assumptions as to future experience which reflect the experience and circumstances of the insurer and which are:

(a) made using judgement and experience;

(b) made having regard to reasonably available statistics and other information; and

(c) neither deliberately overstated nor deliberately understated.

18. It should be recognised that where experience is highly volatile, model parameters estimated from the experience can also be volatile. The intention is for the central estimate to reflect as closely as possible the likely future experience of the insurer. To this end, Judgement may be required to limit the volatility of the assumed parameters to that which is justified in terms of the credibility of the experience data.

19. The central estimate will generally be measured as the present value of the future expected payments. This measurement process will involve prospective calculations and modelling techniques, and will require assumptions in respect of the expected future experience, taking into account all factors which are considered to be material to the calculation, including:

    (a) discount rates (see paragraphs 29-31);

    (b) claims escalation;

    (c) claims expenses; and

    (d) the pattern of claims run-off.

    This is equally applicable to the determination of the gross insurance liabilities and the estimation of reinsurance recoveries.

20. In establishing the central estimate assumptions, due regard should be had to the materiality of:

    (a) the class of business being considered; and

    (b) the effect of particular assumptions on the determined result.

21. Many of the assumptions should be consistent for the estimation of the Outstanding Claims Liabilities and the Premiums Liabilities. Where there are differences, the reasons must be clearly documented.

The Risk Margin

22. For the purposes of paragraph 9, the risk margin is the component of the value of the insurance liabilities that relates to the inherent uncertainty in the central estimate. The risk margin does not relate to the risk associated with the underlying assets, including asset-liability mismatch risk. As the risk margin represents an additional component of the liability value, it is therefore aimed at ensuring that the value of the insurance liabilities is established at an appropriate and sufficient level (as defined in paragraphs 10-11).

23. Risk margins should be determined on a basis that reflects the experience of the insurer. Professional judgement will be needed to determine the risk margins for the insurer as a whole, and for each class of business. In determining risk margins, regard should be had to the objective of this Standard, any other guidance or any relevant professional standards.

24. In considering the methodology and assumptions to be used in determining the risk margin for a class of business, regard should be had to a range of factors, including:

    (a) the robustness of the valuations models;

    (b) the reliability and volume of the available data;

(c) past experience of the insurer and the industry; and

(d) the particular characteristics of the class of business.

25. Estimation of the coefficient of variation may, itself, present technical difficulties with some components of the uncertainty in the central estimate not permitting statistical analysis. Generally, estimation of the coefficient of variation will require judgement as well as technical analysis. As with other aspects of this Standard, regard should be had to the intent underlying the valuation of insurance liabilities in making these judgements.

26. The risk margin should normally be determined having regard to the uncertainty of the net insurance liabilities, but consideration should also be given to any additional uncertainty related to the estimate of reinsurance recoveries.

27. While the risk margin plays a role in achieving an appropriate pattern of profit emergence for a class of business, it is not appropriate to use the risk margin as a tool for smoothing the effect of changes in assumptions or valuation methods.

28. From year to year, risk margins would generally be a constant percentage of the central estimate for each class of business, unless there has been a material change in uncertainty. Such changes may include changed reinsurance arrangements, changes in the insurer's gross risk profile or volume of business, or structural changes, eg legislative requirements.

The Discount Rate

29. The value of an insurer's liabilities is typically independent of the value of the underlying assets. For this reason, a discount rate that is observable, market-based and objective is most appropriate.

30. The rate to be used in discounting the expected future claims payments for a class of business is the gross redemption yield, as at the calculation date, of a portfolio of sovereign risk securities with a similar expected payment profile to the insurance liabilities for that class (eg Commonwealth Government securities for Australian dollar liabilities).

31. Where the expected payment profile of the liabilities cannot be matched - for example, because the duration is too long - a discount rate regarded as consistent with the intention of this Standard should be assumed.

Methodologies for the Valuation of Insurance Liabilities

32. It is not the purpose of this Standard to be prescriptive in terms of the methods to be adopted for the valuation of the insurance liabilities. The appropriateness of any methodology will depend on:

    (a) the class of business;

    (b) the nature, volume and quality of the available data;

    (c) the circumstances of the insurer; and

    (d) considerations of materiality.

33. Where an Approved Actuary provides advice on the valuation of insurance liabilities, it is considered necessary that, subject to considerations of materiality, comprehensive actuarial analyses and modelling techniques will be employed. While the principles of establishing the central estimate and risk margin in respect of each class of business are described in this Standard, it remains the professional responsibility of the Approved Actuary to determine an appropriate methodology. Guidance Note GGN 210.1 *Actuarial Opinions and General Insurance Liabilities* contains a range of suggested methodologies that may help the Approved Actuary in calculating insurance liabilities. GGN 210.1 should be used as interim guidance until the Institute of Actuaries of Australia releases its own professional standards and guidance notes in this area.

34. Approximate methods may be employed in the valuation of the insurance liabilities, subject to the principles of this Standard and where the result so produced is not material or not materially different from that which would result from a full valuation process. Short tail business, for example, may justify the use of approximate methods to the extent that future expected claims are not discounted. Similarly, an approximate method which Mortgage Lenders insurers might adopt in the valuation of insurance liabilities, is to establish case estimates for reported claims, and to construct a premium earning pattern designed to hold back premium so that it is earned in line with expected claims reporting patterns.

35. An insurer may use an approximate method to assess if its Unearned Premium Provision (UPP), less the value of its Deferred Acquisition Expense (DAC), is a reasonable approximation of its Premiums Liabilities. If the assessment suggests that the insurer's Premiums Liabilities would not be materially higher from a more detailed investigation then the insurer may use its UPP less its DAC as the central estimate of its total Premiums Liabilities after adjusting for the profit margin in the UPP. For the purposes of this assessment, materiality should be judged in terms of the impact on the balance sheet and solvency of the insurer. In considering the appropriateness of such an approach, the Approved Actuary should have regard to, among other things:

    (a) any recent assessments of outstanding claims undertaken by the Approved Actuary since the previous calculation date of the insurer;

(b) trends in, and the stability of, the insurer's net combined ratios and net loss ratios over the previous three accident years, including the current year, relative to the level the insurer needs in order to achieve its required return on capital. The Approved Actuary should make adequate allowance for working losses, large claims and catastrophes;

(c) trends in, and the stability of, the insurer's profits over the previous three financial years, including estimates of the likely profit for the current year. The Approved Actuary should make adequate allowance for working losses, large claims and catastrophes;

(d) the insurer's experience with respect to premium rate changes over the previous three years per unit of exposure, eg significant premium rate increases in classes that have had historically high loss ratios. The Approved Actuary should also consider the impact of major changes to the insurer's underwriting and claims management systems;

(e) trends in the rate of growth in exposure for the insurer over the previous three years. The Approved Actuary should analyse premium growth arising from increases in exposure, adjusted for acquisitions, divestment of portfolios, new classes etc;

(f) recent trends and likely developments in the insurer's reinsurance arrangements and rates; and

(g) proper allowance for claims handling, policy administration and other management expenses.

36. The onus for justification of the appropriateness of any approximate method rests with the Board of the insurer and, where relevant, the Approved Actuary. Where an Approved Actuary has been involved in the valuation of the insurance liabilities, then the Approved Actuary must report in his/her written advice on the reasons for, and the effect of, any approach to the determination of risk margins other than one consistent with paragraphs 22-28.

Estimation of Reinsurance Recoveries

37. Reinsurance refers to arrangements where some part of individual or aggregate insurance risks are ceded to another insurer or insurers. This includes cessions of direct writing insurers to reinsurers or other direct writing insurers, as well as retrocessions of reinsurers to their parent insurers or other reinsurers. Reinsurance recoveries are amounts expected to be recovered under arrangements in relation to the Outstanding Claims Liabilities and the Premiums Liabilities.

38. The valuation of net (of reinsurance) insurance liabilities is to be determined in accordance with the principles of this Standard. The principles of this Standard should be applied with similar robustness to the valuation of gross (of reinsurance) insurance liabilities.

39. In practice, the estimation of the value of the insurance liabilities may be either undertaken on a gross basis, with a separate estimate of the value of reinsurance recoveries, or on a net basis. Where the process is undertaken on a net basis, it is still necessary to value separately estimates of the gross liability and the recovery amounts.

40. In determining the estimate of reinsurance recoveries, the principles of this Standard must be complied with. Where the advice of an Approved Actuary is required in regard to the valuation of the insurance liabilities, the Approved Actuary should also consider the estimation of reinsurance recoveries. Actuarial judgement should be used in the application of the principles of this Standard in those circumstances.

41. The estimation of the value of reinsurance recoveries would normally be undertaken on the basis of a class of business. However, there are certain forms of reinsurance where recoveries depend on the combined claims experience of several classes.

Claims Escalation

42. Appropriate allowance must be made for future claims escalation when determining the central estimates of both the Outstanding Claims Liabilities and the Premiums Liabilities. Future claims payments may increase over current levels as a result of either or both of:

    (a) wages or price increases (inflation); or

    (b) court awarded interest, other environmental or economic causes (superimposed inflation),

    and appropriate allowance must be made in both respects. Claims payments include third party costs incurred in settling those claims such as investigation, medical and legal fees, etc.

Non-Reinsurance Recoveries

43. Non-reinsurance recoveries are amounts that may be recovered under arrangements other than reinsurance arrangements. These would include salvage, subrogation and sharing agreements. The treatment of non-reinsurance recoveries should be consistent with that required by relevant Australian Accounting Standards.

Materiality

44. Particular values are considered material to the overall result of a calculation when their misstatement or omission would cause the result to be misleading to the users of the information. Materiality tests assess the significance of the particular value by relating it to the amount of the overall result (the base amount) to which it contributes.

45. Materiality will always be a matter requiring exercise of judgement. It should be recognised that the level at which a difference becomes material can be considerably lower than a statistically significant difference. In these circumstances, careful exercise of judgement is required.

Reporting Requirements

46. Paragraphs 25 to 31 of Guidance Note GGN 220.1 set out details on the content of an Approved Actuary's report on liabilities.